

**UNIVERSITY OF JOHANNESBURG****DEPARTMENT OF ACCOUNTANCY****AUDITING 200 – 2014****REPLACEMENT ASSESSMENT OPPORTUNITY****DECEMBER 2014**

**FIRST EXAMINERS:** MS. C HOHLS  
MS. MARCHBANK

**TIME:** 150 MINUTES

**SECOND EXAMINER:** MRS I NEL  
MRS. D MARE

**MARKS:** 125 MARKS

**INSTRUCTIONS:**

1. This paper consists of **FOURTEEN** pages. If your paper does not contain all the pages, please put up your hand so that a replacement paper can be handed to you.
2. Answer all the questions.
3. Answer each question on a **separate folio**.
4. Calculate the time that you should spend on each question by multiplying the number of marks for each question by 1,2 to determine the time, in minutes, available for each question. Adhere to these time constraints in order to finish the paper in the given time.
5. Delete **all** (even single open lines) open spaces on your answer sheets with pen. Pages on your answer sheets that contain open spaces will be marked as such and those pages will not be eligible for a remark.
6. No tippex or pencil may be used on your answer sheets. Pages on your answer sheets that contain pencil or tippex will be marked as such and will not be eligible for a remark.
7. All the examination regulations of UJ and the policy document for students of the Department of Accounting will apply during this assessment.
8. Keep this paper for your record purposes.
9. The neatness, disclosure and presentation of your answers will be taken into account when marking your paper.
10. Read questions carefully, if you need to provide explanations you should always use full sentences, refrain from simply naming facts.

## QUESTION 1

28 MARKS

You are an audit manager employed at Oceanic Auditors Inc. for the past 15 years. Oceanic Auditors Inc. is a medium sized audit firm situated in the heart of Cape Town with stunning views of Table Mountain.

One of your clients is the Dolphin Dive Aquarium Ltd. They have been your client for the last four years over which you came to know the Financial Manager, Mrs Winter CA(SA), quite well on the golf course every weekend. It is safe to say that the two of you became quite good friends during this time.

Just before you had to start planning the audit for the 2014 financial year, you received a phone call from Mrs Winter, asking you to meet her as she had a matter to discuss with you. You agreed to meet with her even though you felt the request to meet after hours was a bit strange.

Once at the meeting, Mrs Winter informed you of her situation as follows:

“At the mid-year board meeting it has been decided that the aquarium needs a better, faster and more modern computer system as the old one took just too long to process information and couldn’t handle the increase in sales over the last year.

Since we have a really good IT department, the board decided that the IT guys will write a new system for us which is customized to our needs. No one on the board had a problem with this as no one really knew what it meant and what controls need to be in place and with me not being a director, no one wanted to listen to me with regards to the controls that needs to be put in place.

I’ve pretty much been kept out of the loop with this whole conversion of the system and was just informed that I need to be here on Saturday as that is when they will convert the system. Which brings me to the reason I requested the meeting. The board doesn’t want the auditors to know about the change over, as they have to be present and will have to be paid. They do not want to explain why they did not follow proper protocol with the conversion of the system. My request is, will you please be here on Saturday with me to oversee the conversion – so that there are independent supervision. The only controls followed during the development of the system is as follows:

- Approval from the board has been obtained
- Part of the system has been tested in a spot check manner.
- They only got one quote and used that quote
- They only backed up quarter of the files
- Just the front office received training
- Deadlines weren’t set out for the entire process, just the first three weeks
- In order to keep the process as cheap as possible the auditors were left out of the process
- Project management team were put together but they didn’t perform a feasibility study as they felt it’s unnecessary.

Please let me know if you'll be able to make it."

Later that evening, while working on another client you received an email from the Financial Director, Mr Flipper, stating that he will be resigning after the 2014 financial year end as he received a very good job opportunity. He told you that he needs you to ensure you give him a good audit opinion this year as it will have an impact on his salary at the new company and said that if you don't, he will ensure that you do not become partner at any audit firm ever.

Your spouse has recently learned that she has been appointed to replace Mr Flipper as financial director at Dolphin Dive Aquarium Ltd after he leaves. The remuneration package offered was a very generous package.

YOU ARE REQUIRED TO:				MARKS:
a.	Based on the information provided:			(14)
	1. Explain the weaknesses in the development and conversion of the new system			
	2. Provide additional controls/recommendations to management to address the weaknesses / lack of controls			
Your answer should be in the following format:				
		Shortcoming/wrong application:	Recommendations:	
b.	Provide any threats to the fundamental principles in the CPC evident from the above scenario and provide safeguards to mitigate these threats to an acceptable level			(10)
	Your answer should be in the following format:			
	Issue	Threat	Principle	
c.	Based on the information provided, discuss whether a combined or a substantive approach will be followed during this audit.			(4)
TOTAL				(28)

**QUESTION 2****25 MARKS**

**This question comprises of two (2) parts.**

**PART A****17 MARKS**

You have recently been approached by Jion (Pty) Ltd to be their new auditor. The company's year-end is 28 February 2014. Your audit firm has never audited a piggery before. There is limited audit staff at the moment in the firm as this is a busy time of year for an audit and many of your staff have already been booked onto other clients planned months in advance.

The following working papers have been supplied to you for your perusal:

- A100 – Background information
- A301 – Notes of pre-engagement meeting with CFO Jion (Pty) Ltd.

<b>Client:</b> Jion (Pty) Ltd	<b>Year-end:</b> 28/02/2014	<b>A100</b>
<b>Prepared:</b> N Pi	<b>Date:</b> 03/03/2014	
<b>Reviewed:</b>	<b>Date:</b>	
<b>Subject:</b> Background information		
<p>Jion (Pty) Ltd is situated in Pietermaritzburg and was founded in 1989 by Kevin Bacon (CEO) and his wife Julia (CFO) who were initially sole shareholders until 2013. Join (Pty) Ltd farms with pigs in an organic manner.</p> <p>The company is so well known that other super market entities are on long waiting lists to be as their preferred supplier of pork. The company distributes its pork produce all over South Africa. Since the inception, their pork rashers and pork sausages have become very popular and this had led to the opening of another piggery in Gauteng in order to meet the Gauteng demands.</p> <p>In December 2013 a company called Escort Limited acquired 75% if the share capital of Jion (Pty) Ltd to assist with the demand for expansion and assisting capital for expansion. Julia decided to resign after the sale of the shares and dedicated herself to being a mom. Kevin Bacon remained as CEO and also took the role as the acting CFO until a suitable replacement is found.</p> <p>Part of his remuneration is performance based with the option of receiving shares from the holding company via a share incentive scheme if certain sales and profit targets are met.</p>		

<b>Client:</b> Jion (Pty) Ltd	<b>Year-end:</b> 28/02/2014	<b>A301</b>
<b>Prepared:</b> N Pi	<b>Date:</b> 03/03/2014	
<b>Reviewed:</b>	<b>Date:</b>	
<b>Subject:</b> Notes of pre-engagement meeting with CFO Jion (Pty) Ltd.		

Date:	1 March 2014
Time:	08:00
Attendees:	Auditors – Audit 200 student
Client:	Kevin Bacon (CEO) and (CFO) – Jion (Pty) Ltd George See (CFO - Escort Limited)

**Minutes of meeting**

**1. Purpose of meeting**

To obtain information to consider Jion (Pty) Ltd as an audit client for 2014 audit.

**2. Previous auditors**

The previous auditors Midway Auditing Incorporated, qualified the 2013 financial statements on the basis that they did not observe a physical stock count at the Gauteng branch in Bassonia as at 28 February 2013 and were also not able to satisfy themselves through alternative means of inventory audit procedures with respect to work in progress quantities and values as at 28 February 2013 due to the lack of proper accounting records for the count. Inventory at the Pietermaritzburg branch was also considered material to the financial statements.

As part of the engagement procedures you contacted Midway Auditing Incorporated and received a letter from the partner in which he stated that he will immediately resign from 2014 audit and that except for the certain tax issues, no reason exists for not accepting the audit. He also informed you that they had a fire at their offices and that unfortunately the audit file together with fixed asset registers they maintained for the company over the past couple of years were destroyed by the fire.

**3. Financial Information**

Kevin Bacon reported that all sales targets for 2014 will be met and that turnover will be in excess of R200 million once the books are finalised. He further stated that profitability will however be under pressure due to the possibility of a pig disease which has broken out in the Natal area. Jion (Pty) Ltd applies IFRS for SMEs as their accounting framework.

**4. Bad press**

Your background check confirmed that the company and its directors did not highlight significant risks except for the Business Day article in which Tekki (Pty) Ltd laid a complaint against Jion (Pty) Ltd with advertising board of South Africa for their claim of a grown market share claim of 25% in South Africa.

**5. Other information**

The audit partner is the cousin to Julia.

The engagement letter will be signed after the audit, important to get going on audit now as the deadline is 25 March 2014.

<b>YOU ARE REQUIRED TO:</b>		<b>MARKS</b>
<b>a.</b>	With reference to the information contained in document <b>A100</b> and <b>work paper A301</b> , discuss the matters that your audit firm should consider in deciding whether or not to accept the appointment as Registered Auditor of Jion (Pty) Ltd.	<b>(14)</b>
<b>b.</b>	Do you think the audit engagement should be accepted? Explain your answer based on your findings in (a) above.	<b>(3)</b>
	<b>TOTAL</b>	<b>(17)</b>

**PART B****8 MARKS**

Your audit firm has been in operation for four years now. Three of your best friends and you decided that after their articles they would start an audit firm. The composition of the audit firm is as follows:

- Jack Black SA(SA), RA
- Snow White, SAPIA, RA
- Dave Green CA(SA), RA
- Larry Steel B.Com Honours, RA

The name of the firm is Excel Auditors Incorporated. Each director is also a shareholder.

IRBA issued a practice number 903668 to the firm and has been paid annually for the past four years for their annual IRBA membership fees.

<b>YOU ARE REQUIRED TO:</b>	<b>MARKS</b>
Based on the additional information provided, discuss the appropriateness of IRBA to impose fines on this audit firm, Excel Auditors Incorporated and discontinue the firm as a registered auditor firm.	<b>(8)</b>
<b>TOTAL</b>	<b>(8)</b>

**QUESTION 3****35 MARKS**

You are an audit manager at Cuttlebug Auditors Inc. and are currently busy with the planning of Bugs Alert Ltd (hereafter BA) audit for the 2014 financial year end. The financial year end of BA are 28 February 2014.

Information obtained about the Company and the industry are documented in the extracts of the work paper **145** below:

<b>Client:</b> Bugs Alert Ltd	<b>Period end:</b> 28 February 2014	<b>145</b>
<b>Prepared by:</b> C Voyant	<b>Date:</b> 20 February 2014	
<b>Reviewed by:</b>	<b>Date:</b>	
<b>Obtaining information about the entity &amp; its accounting system</b>		
<ul style="list-style-type: none"> <li>- BA are in the business of providing exterminating services to corporate companies throughout South Africa.</li> <li>- BA has a consistent flow of income which increased by 10% in the current year when compared to the prior year. The increase is in line with the growth in clientele.</li> <li>- BA is also the market leader when it comes to the providing of exterminating services.</li> <li>- The Financial Manager resigned in the middle of the year to go to Australia with her husband. The position was vacant for three months and only filled in December 2013.</li> <li>- During the last three financial years BA received unqualified audit reports which made the Financial Director, Mrs. Ladybird, very happy. She hopes that BA can get an unqualified audit report for the 2014 audit as well since the new Financial Manager, Mr. Arachnida, had time to settle in and learn the ropes by now.</li> <li>- During the current financial year BA was involved in litigation where they were accused of price fixing for certain services. BA managed to keep the litigation proceedings from the press, but lost the litigation and had to pay a fine.</li> <li>- BA have been using the same computer system for the last 5 years and made annual updates to ensure that they have the latest software on their system at all times.</li> <li>- Controls have been tested and it was found that all controls are working effectively and can be relied upon.</li> </ul>		

You have decided to give the responsibility of obtaining bank confirmations to the first year clerk.

Three weeks after the confirmation has been sent to the bank and no confirmation has been received back you asked one of the third years to follow up on the matter. The third year's response were as follows:



“I phoned the bank and they said that they sent the bank confirmation last week already. They did not receive any instruction from the first year as to where the confirmation needs to be sent and have sent it to the financial manager directly.”

Upon requesting financial information to determine materiality, you were provided with the financial information as per annexure A. While investigating the 2014 financial information per the trial balance, you came upon a new account where monthly payments were made to. When you queried this matter with the accountant, she turned white and told you to talk to the Financial Director, Mrs Ladybird.

When you asked Mrs Ladybird about these payments, she admitted to authorising these payments to be made as they were made into her own company's bank account. She needed to add to her company's income as the company is not doing so well and she has ongoing expenses to be covered and by taking BA's money and depositing it into her company, BA won't have to pay so much tax. Her company, being a privately owned company, does not have to be audited and thus no one will query the monthly deposits being received. There's anyway no benefits for a private company to be audited.

#### **ANNEXURE A**

<b><u>Indicator</u></b>	<b><u>2013 Audited</u></b>	<b><u>2014 Actual (10 months)</u></b>	<b><u>2014 Budget</u></b>
<b>Turnover</b>	R 495 000	R 499 000	R 530 000
<b>Cost of Sales</b>	R 356 000	R 432 000	R 465 000
<b>General admin expenses</b>	R 285 000	R 302 000	R 320 000
<b>Total assets</b>	R 965 345	R 985 000	R 986 000
<b>Liabilities</b>	R 765 123	R 795 035	R 801 352

<b>YOU ARE REQUIRED TO:</b>		<b>MARKS:</b>
<b>a.</b>	Based on the information provided discuss the steps and considerations to be taken into account in terms of planning the audit of BA.  Your answer should be discussed under the following headings: - Information about the entity and its environment. - Information about the accounting system. - Calculation of materiality.	<b>(19)</b>
<b>b.</b>	With regards to information provided, and with ISA 505 and SAAPS 4's requirements: - What steps should have been taken in terms of obtaining an external bank confirmation? - What procedures need to be performed to determine the accuracy of the legal confirmation in the financial statements	<b>(5)</b>
<b>c.</b>	In terms of the Auditor's Professions Act (APA), discuss the actions of Mrs Ladybird	<b>(6)</b>
<b>d.</b>	Explain to Mrs Ladybird the benefits of having her company audited even though it is a private company.	<b>(5)</b>
<b>TOTAL</b>		<b>(35)</b>

## QUESTION 4

33 MARKS

For quite a number of years your firm has been the auditor of Ziplock (Pty) Ltd, a company which manufactures a large number of plastic items. The company was formed by Ziegfried Lock twenty years ago and has over the years gained a reputation for reliability and sound business dealings.

This reputation has been mainly due to Ziegfried Lock; he has been closely involved in the business and has insisted on honest business practice. Due to his age he has decided to sell 75% of his shares in the company. The average number of employees for the year amounts to 256 staff members. For the past 3 years the average turnover amounted to R200 695 000 per annum. In 2014, the turnover according to the trial balance amounted to 10% more on average than the turnover from prior periods. Current third party liabilities amounts to R1 096 333 for the 2014 financial year end as disclosed in the statement of financial position.

Young aspiring entrepreneurs Mess Up and Bro Ken were appointed as directors of the company. Shortly after their meeting with your audit partners, the question of whether your firm should remain as auditor of Ziplock (Pty) Ltd was discussed. One of your partners who had dealings with Up and Ken, strongly recommended that the firm resign from the audit because of their dubious business reputations with the directors. However, it was decided that the audit would be retained for the current financial year and the situation reviewed thereafter. Ziplock (Pty) Ltd has 15 active shareholders.

Whilst conducting risk assessment procedures for the current audit, it came to your attention that the company appears to have deteriorated drastically due to the irresponsible business practices engaged in by Mess Up and Bro Ken, compounded by their extreme lavish lifestyles.

A number of additional matters have caused you to be concerned:

1. Miss Balance, the financial accountant confided in you that Mess Up had from time to time instructed her to pass various journal entries which she had not really understood or agreed with and for which Mess Up and Bro Ken had not given any clear explanation. In addition to this alarming news, both directors had put through amendments to various master files without adhering to the internal control environment.
2. She also confirms you that there have been numerous phone calls from the bank manager as he is concerned about the overdraft that is ever growing and is requesting a date on which the audited annual financial statements will be available.

During the course of the audit, **where further audit procedures** was completed, the following matters came to your attention:

### 3. *Inventory*

- A large container of plastic containers which was sitting in the inventory yard.
- Moses the warehouse manager informed you that the contents of the container had been rejected by a customer Plastic Seals (Pty) Ltd because of the failure of the plastic to meet BPA requirements. He also informs you that Mess Up had instructed him to include the goods in the inventory count as they could export this to some “African country” where rules and regulations are not so tight. The cost of the inventory is R1 924 222. The production manager informed you that the only feasible course of action would be to melt the plastic containers done and reuse the plastic, this values amounts to R50 000.
- Inventory in the warehouse valued at R159 896 which did not appear on the perpetual inventory system but was included in the inventory list. Bro Ken provided no explanation and said “what’s the matter, the inventory is there!”
- Extension errors during the audit found that inventory sheets amounted to understatement of R163 563.
- The annual allowance for inventory obsolesces has for many years been 10% of inventory cost. No allowance has been made for this. Bro Ken said that this is crazy talk as all plastic stock is inside, who ever came up with that figure and assumption in the first place was crazy.

### 4. *Debtors*

- An amount of R352 000 which had been loaned to Mess UP CC, one of a number of close corporations controlled by Mess Up. The only authority for the loans was a directors minute signed by Mess Up himself, which indicated an indefinite repayment period and an interest of 3%. No other documentation was found.
- The amount of R2 659 236 owed by Plastic Seals (Pty) Ltd for the consignment which it rejected has not yet been reversed. Mess Up argues that at some point a further order will be received from the Plastic Seals (Pty) Ltd customer and therefore we can treat this amount as a pre-invoice amount of that future dated sale. Upon further inspection, there is no correspondence from Plastic Seals (Pty) Ltd supporting this assumption.

In addition to your normal audit procedures, you also paid particulate attention to the journal entries which Mess Up had insisted to pass. You therefore came up with the following result:

- The net effect of a series of very complex entries which had been passed was that a liability of R986 365 raised correctly during the prior year in respect of a capitalised four year finance lease had been written off to cost of sales.
- Although you tested the Masterfile amendments extensively you could not find any satisfactory proof of irregular amendments.

No other matters which you were not able to resolve came to your notice on the audit. You were therefore left to evaluate the materiality for audit reporting purposes of the following:

1. The matters arising out of the inventory audit section,
2. The matters arising out of the debtors audit and
3. The matters arising out of your audit of abnormal journal entries.

Your initial discussions with Mess Up and Bro Ken revealed that that they were not interested in making any changes in respect to other above matters, as they regarded your concerns as over exaggeration.

After careful consideration, you decided that the statement of financial position could contain misstatement of about R458 000 in total assets and R205 369 in total liabilities without being materially misstated. In addition you noted that the statement of comprehensive income reflected a net profit before taxation of R689 365.

### **Additional information**

Mess Up and Bro Ken decided that they had not yet received as much of a bonus for the current financial year as they would have liked and instructed Mr Zing, the human resource manager of the company, to pay each director R1 205 222 worth of cash bonuses each.

YOU ARE REQUIRED TO:		MARKS
<b>a.</b>	<p>State whether you would have assessed the risk of material misstatement at financial statement level as either:</p> <ul style="list-style-type: none"> <li>Low, Medium or High</li> </ul> <p>Based on the information you have about the company. Only consider this information. Justify your answer.</p>	<b>(3)</b>
<b>b.</b>	<p>i) Identify the risks of material misstatement on a financial statement level apparent from the above mentioned information that you may consider during the planning of the MRSA audit.</p> <p>ii) Discuss how the risks identified in (i) above will influence your assessment of: Inherent risk (IR) <b>(3)</b> Detection risk (DR) <b>(3)</b> Control risk (CR) <b>(3)</b> And conclude.</p> <p>iii) With respect to the <b>inventory in the warehouse valued at R159 896 which did not appear on the perpetual inventory system</b>:</p> <p>a) What assertion is affected? <b>(1)</b></p> <p>b) Provide substantive procedures that could be followed by the auditor in respect of the assertion you identified in a) above. <b>(3)</b></p> <p>c) For the substantive procedures above, what would you say is the direction of the testing? <b>(1)</b></p>	<b>(6)</b>  <b>(9)</b>
<b>c.</b>	Discuss whether or not Ziplock (Pty) Ltd should be audited.	<b>(6)</b>
<b>d.</b>	Based on the additional information provided, discuss with respect to the Companies Act of 2008 as to whether there is any concern about the remuneration that was paid to the directors Mess Up and Bro Ken.	<b>(4)</b>
<b>TOTAL</b>		<b>(33)</b>
<b>OVERALL PRECISION AND INTERPRETATION MARKS</b>		<b>(4)</b>